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Mark, Darrell R. and Waterbury, Josie R., "G07-1723 Livestock Risk Protection Insurance" (2007). *Historical Materials from University of Nebraska-Lincoln Extension*. 4100.

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Livestock Risk Protection Insurance

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This NebGuide discusses Livestock Risk Protection insurance available to feeder and fed cattle producers and swine producers.

What is Livestock Risk Protection Insurance?

Livestock Risk Protection (LRP) Insurance offers single-peril price risk protection to feeder and fed cattle producers and swine producers. Producers are able to protect against declining cattle or swine prices by purchasing an insurance product that pays livestock producers if a national or regional cash price index falls below an insured coverage price level. Essentially, a coverage price is selected by the insured, and if the cash price index is below that coverage price at the end of the policy, an indemnity equal to the difference is paid to the insured producer. Because the LRP contract is market-based, coverage prices and premiums change daily. Although LRP offers price level protection, producers using LRP are still exposed to a type of basis risk. Thus, successful

use of the contract by producers will require knowledge of local LRP basis, or the difference between local prices and the cash price index.

LRP is a revenue insurance program that is reinsured and subsidized by the Federal Crop Insurance Corporation (FCIC). The program operates much like a put option in that it allows producers to establish a floor price for protection with the ability to participate in price rallies. In return for this protection, the producer pays a premium for the price insurance.

All owners of livestock located in one of 37 eligible states (*Figure 1*) can apply for an LRP policy with a licensed crop insurance agent. The USDA Web site, <http://www3.rma.usda.gov/apps/agents/>, provides an Agent Locator Tool that lists agents who are eligible to sell LRP.

To enroll, a producer must contact a licensed agent and complete an application. The application asks for general information such as address, phone number, Social Security number, and type of livestock to be insured. Once the application is approved by USDA, a producer is officially enrolled in the program. Enrollment establishes the right, *but not the*

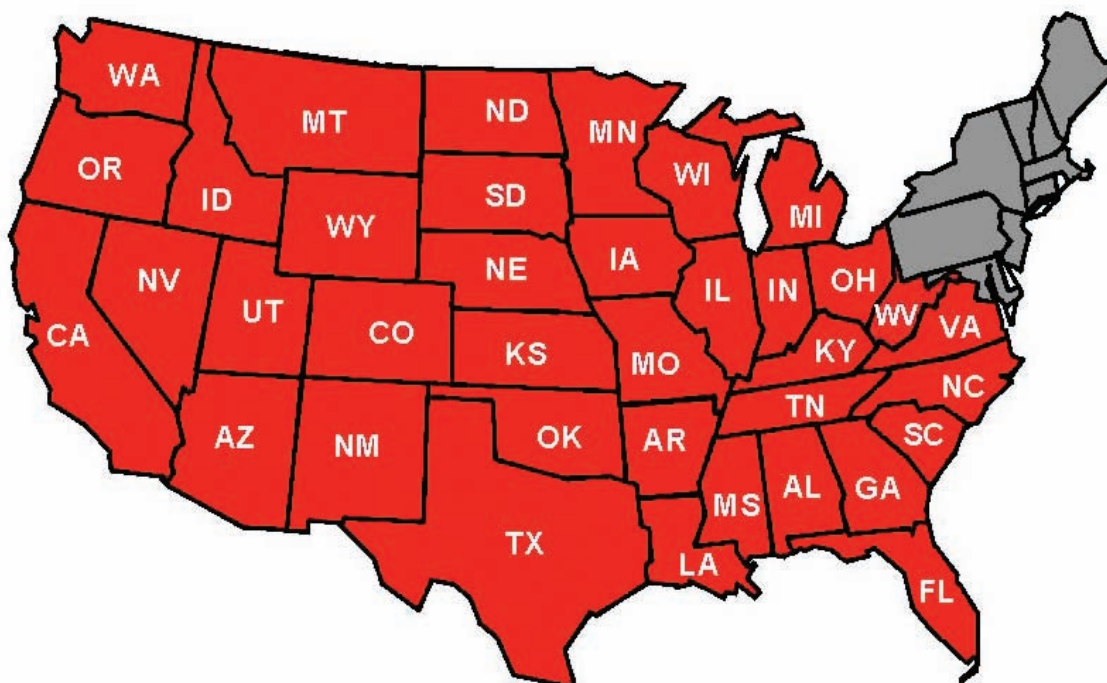


Figure 1. States with LRP, 2008.

obligation, to purchase coverage and incurs no cost to the applicant. The actual price insurance coverage is obtained with a Specific Coverage Endorsement (SCE), which can be thought of as an addition to the basic policy that binds coverage.

Feeder Cattle

Feeder cattle insurable under LRP are divided into two weight classes — less than 600 pounds and 600 to 900 pounds. Steers, heifers and Brahman and dairy breeds in both weight classes can be insured. Also, bull calves of any breed expected to weigh less than 600 pounds can be insured. Feeder cattle producers select insurance periods of 13, 17, 21, 26, 30, 34, 39, 43, 47 or 52 weeks, depending on when the cattle are expected to be marketed. The feeder cattle program allows producers to insure up to 2,000 head of cattle per crop year (LRP insurance year is July 1 to June 30) with a limitation of 1,000 head of cattle per Specific Coverage Endorsement (SCE). Producers are able to select coverage levels between 70 percent and 100 percent. The Chicago Mercantile Exchange (CME) Feeder Cattle Price Index is used to measure cash feeder cattle prices and then compared to the coverage price to determine whether an indemnity will be paid. When insuring feeder heifers, lighter weight cattle, or Brahman or dairy breeds, the same index is used as a base, but an adjustment factor is included.

The feeder cattle LRP insurance contracts, while similar to put options, offer advantages to producers not available with futures options or futures contracts. First, a CME feeder cattle futures contract is based on 50,000 lbs, or 67 head of 750 lb feeder steers. For producers with a smaller number of cattle, LRP can be used without “over insuring” (any number of cattle less than 1,000 head can be insured per SCE). Thus, producers with smaller herds could find the most benefit from LRP. Another advantage to LRP insurance is that 13 percent of the premium is subsidized. Another subsidy covers the administration of the insurance contracts and agent commission.

Fed Cattle

Fed cattle that are insurable include both steers and heifers that are expected to finish with a Select or higher quality grade, Yield Grade one to three, and weigh between 1,000 and 1,400 pounds (live weight basis). Fed cattle producers are able to select insurance periods of 13, 17, 21, 26, 30, 34, 39, 43, 47 or 52 weeks, and can insure up to 4,000 head of cattle per crop year (LRP insurance year is July 1 to June 30) with a limitation of 2,000 head of cattle per SCE. Fed cattle producers select coverage levels between 70 percent and 100 percent. The 5-Area Weekly Weighted Average Direct Slaughter Steer Price for steers grading 35 percent to 65 percent choice sold FOB feedyard on a live weight basis as reported by USDA’s Agricultural Marketing Service (AMS) is used as the cash fed cattle price. This cash price is then compared with the coverage price to determine whether an indemnity will be paid.

The fed cattle LRP contract is subsidized by FCIC like the feeder cattle contract.

Swine

For the swine program, producers must expect the insured market hogs (barrows and gilts) to weigh 150 to 225 pounds on a dressed weight basis when sold. Swine producers are able to select insurance periods of 13, 17, 21 or 26 weeks, and can insure up to 32,000 head of swine per crop year (LRP insurance year is July 1 to June 30) with a limitation of 10,000 head of swine per SCE. Swine producers select coverage levels between 70 percent and 100 percent. The two-day volume weighted average of the “Negotiated” and “Swine or Pork Market Formula” national net prices is used as the cash swine price. This average is equivalent to the Chicago Mercantile Exchange Lean Hog Cash Index, which uses the data from the USDA-AMS. Additionally, this cash average is compared with the coverage price to determine whether an indemnity will be paid.

How Livestock Risk Protection Works

As indicated earlier, LRP provides single-peril price-risk protection. To hedge against downside price risk with the LRP contract, producers select a coverage price, which is based on a percentage coverage level (between 70 percent and 100 percent) of an expected ending value. For example, if the expected ending value of feeder steers after a 21 week period was \$111.47/cwt, a coverage level of 92 percent would yield a coverage price of \$102.55/cwt ($\$111.47/\text{cwt} \times 92\%$). If, at the end of the 21-week period the CME feeder cattle price index is higher than \$102.55/cwt, no indemnity is paid. However, if the index is lower than \$102.55/cwt, an indemnity equal to the difference between the coverage price and actual ending value of the CME feeder cattle price index is paid. The cost for this insurance based on May 2007 market prices was about \$1.85/cwt (before the 13 percent subsidy). Suppose that the CME index actual ending value was \$101.05/cwt. In this case, a \$1.50/cwt indemnity would be paid. The minimum sale price (\$102.55/cwt) would be achieved by selling the feeder cattle for \$101.05/cwt in the cash market, plus the \$1.50/cwt LRP indemnity. If the producer sold the feeder cattle for more than \$101.05/cwt in the cash market, a price higher than the insured minimum sale price would result. However, if the feeder cattle were sold for less than \$101.05/cwt in the cash market, the net price received would be less than the insured minimum sale price. Thus, basis, or the difference between the CME index and actual cash market sale price, is critical when using LRP to manage price risk. Because LRP does not lock in basis, it is important for producers to understand and anticipate the basis in the markets in which they sell cattle. For more information regarding basis risk, consult *Hedging and Basis Considerations for Feeder Cattle Livestock Risk Protection Insurance* (Extension Circular 835).

The fed cattle LRP works similarly; however, the AMS five-area weekly weighted average direct slaughter steer price is used as the ending value, rather than the CME feeder cattle index. Hedging techniques and basis risk considerations for fed cattle are described in detail in *Hedging and Basis Considerations for Fed Cattle Livestock Risk Protection Insurance* (Extension Circular 834). Swine works similar to the example

described above; however, the Chicago Mercantile Exchange Lean Hog Cash Index is used as the ending value. Hedging and basis risk for swine are described in detail in *Hedging and Basis Considerations for Swine Livestock Risk Protection Insurance* (Extension Circular 833).

How to Enroll in Livestock Risk Protection

LRP is available in 37 states (*Figure 1*). To be eligible for this policy, the insured fed cattle, feeder cattle, or swine must be located in one of the 37 states. It is not necessary for the owners of the livestock to reside in the eligible state — only the insured livestock must be located there.

Before producers are able to purchase LRP insurance, they must obtain a policy through a licensed LRP agent. To do so, producers must submit an LRP application, a Substantial Beneficial Interest (SBI) form, and an LRP disclaimer form. The application form determines if producers are eligible to purchase LRP insurance and lists the conditions of acceptance in the LRP insurance program. The SBI form establishes eligibility (verifies that the producer has at least 10 percent ownership of the cattle), accounts for insurance limits, and determines the number of cattle that will be insured by the producer. The statements on the LRP disclaimer include specific regulations and rules regarding the collection of indemnity payments to which producers must agree. Any crop insurance agent can become certified to sell LRP insurance. A list of certified LRP agents is available at <http://www3.rma.usda.gov/apps/agents/>.

Once the application is accepted, producers purchase LRP coverage by filing a Specific Coverage Endorsement (SCE) with a licensed LRP agent, who then verifies the number of cattle that will be insured. With the SCE filing, producers establish the coverage level, price, premium, and length of coverage. Producers can obtain insurance between approximately 5 p.m. and 9 a.m. Central Time, Monday through Friday, (excluding federal holidays).

The prices for the LRP program change daily, so the premium for the insurance coverage is established at the time of purchase (filing the SCE). Current prices for the LRP program are available at http://www3.rma.usda.gov/apps/livestock_reports/.

At the end of the selected insurance period, if the coverage price is greater than the actual ending value price reported by USDA-AMS (fed cattle) or CME (feeder cattle and swine), an indemnity payment is paid to the producer. To receive the indemnity payment, producers must submit a LRP claim form within 60 days of the ending date of the insurance contract. Payment is based on the actual ending value determined by the AMS or CME reported prices. The indemnity payment will be paid within 60 days after the claim form is submitted to the insurance agent. The actual ending values can be found at http://www.ams.usda.gov/mnreports/lm_ct150.txt (fed cattle) and <http://www.cme.com> (feeder cattle and swine), or at the RMA website. If the coverage price is less than the livestock price reported by AMS or CME, no indemnity payment is paid to the producer.

What LRP Means for Livestock Producers

The LRP insurance program reduces downside price risk for livestock producers, but it does not eliminate all risks. The LRP insurance program does not cover sickness or death of the cattle or the possibility of rising feed costs. Further, producers are also subject to basis risk (the risk that basis declines relative to their forecast used to create their expected minimum sale price).

The value of the LRP insurance contracts to livestock producers will depend upon the premiums for the contracts relative to other risk management tools, including put options. Certainly, however, the LRP program provides another choice for price risk management, and may be especially useful for producers with small operations.

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Issued June 2007

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